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The Reorganisation and Restructuring of Corporate Real Estate

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Abstract

Corporate real estate constitutes a large percentage of fixed assets of a firm. Changing economic, regulatory, competition and financing situations cause firms to undertake corporate reorganization and restructuring. With the accompanying financial and operational restructuring, corporate real estate in a firm is very often involved.

Various techniques of corporate reorganization and restructuring are available for decision makers to change the composition of corporate real estate to be realigned to the new business objectives of the firm. Among the techniques of corporate real estate reorganization and restructuring are divestiture, acquisition, spin-off, joint venture and going private etc.

This article will focus on divestitures and acquisitions in releasing hidden corporate real estate values.

Keywords : reorganization and restructuring, corporate real estate

1.0 Introduction

Changes in the competitive, economic, financial and regulatory conditions call for changes in the corporate organization to meet the new business environment. Very often such changes require revamping the organizational structure of a firm by going through corporate reorganization and restructuring. Managers make changes to asset holdings, financial structures, corporate governance and ownership to enhance the competitive positions of the firms.

One of the key assets in a firm that can be restructured is corporate real estate (CRE). Corporate firms own a significant amount of real estate for operation, occupation, investment and development. CRE has to be managed as an integral part of business resource management in the face of intense competition and technological advances. Among the techniques to reorganize corporate real estate are through property acquisitions, disposals, joint venture and sale and leaseback.

Reorganisation and restructuring of CRE is found to increase shareholder's wealth as empirical research shows that changes in absolute real estate holdings through acquisitions, disposals, spin-offs or joint ventures can have the effect of reducing systematic risk and increasing corporate value.

Corporate companies could achieve its restructuring objectives by undertaking strategies as shown in Table 1. A company could improve its existing balance sheet through reallocation of assets and reorganizing its financial claims.

Table 1 : General framework for corporate real estate reorganisation and restructuring

STRATEGY / TECHNIQUES	**CORPORATE ACTIVITIES**
REORGANISATION OF ASSETS	Acquisitions Divestitures
CREATING NEW PUBLIC OWNERSHIP ORGANISATION/RELATIONSHIP	Split-offs Split-ups Equity carve outs
CREATING NEW PRIVATE OWNERSHIP ORGANISATION/RELATIONSHIP	Going private transactions (LBO, MBOs) Joint ventures
EXPANSION	Merger and acquisitions Tender offers
REORGANISING FINANCIAL CLAIMS	Liquidation Bankruptcy Exchange offers Leveraged recapitalisations

(Source : Adapted from Weston, Siu and Johnson (2001) and Logue, D E (1995))

1.1 The role of corporate real estate in corporate companies

Joroff et al. (1993) has termed CRE as the *'fifth resource'* after the traditional resources of people, technology, information and capital. Real estate is traditional perceived as a cost centre and is manage passively. But as a business resource, real estate constitutes the second highest category of costs after salaries. Thus there is a need to manage corporate real estate effectively and efficiently.

The seminal work on corporate real estate is by Zeckhauser and Silverman (1981 and 1983) who had surveyed major corporations in US and found that the average firms' real estate assets is about 25% of total assets with manufacturing firms constituting 40% of their sample. Veale (1989) replicates and expands the earlier study by Zeckhauser and Silverman (1981) and generally confirms their results.

The total value of the real estate stock in the US in 1990 was about US$8.777 trillion. Corporate companies owned US$1.633 trillion out of the total $2.655 trillion commercial real estate in the US (DiLuia, Shlaes and Tapajna 1991).

Further research on the level of real estate ownership by non-real estate companies have been conducted internationally. Results of these studies show significant ownership of real estate which range from 25% to 40% of their total assets by non-real estate firms :

(a) United States of America (Veale 1989; DiLuia, Shlaes and Tapajna 1991; Johnson and Keasler 1993),
(b) New Zealand (Teoh 1993),
(c) Malaysia (Iskandar 1996),
(d) Europe (Bon 1998)
(e) Germany (Schaefers 1999),
(f) Singapore (Liow 1999; Ong and Yong 2000 and Liow 2001)
(g) Ireland (Roulac et. al. 2002).

Hence there is a need to control corporate real estate as it impacts on the costs of the companies. Property is an essential factor of production but a costly one. Many companies have little idea of their property costs and the extent of their interests and their value. Real estate also requires skills that differ from running business profitably.

In addition, companies that do not manage real estate efficiently may face hostile corporate takeovers. The literature on merger and acquisition indicate that corporate takeovers arise because of undervalued real estate assets of the target company (Ambrose 1990).

1.2 Characteristics of corporate real estate

The composition of corporate real estate varies with the type of business being carried out by the respective companies. The property type and amount owned is dictated by the nature of its operations.

For manufacturing companies, it would have factory premises, offices and warehouse and land for future expansion/development. These properties could be located in several locations.

Major food retailers would own warehouses and distribution centres and are active in the acquisition of properties for its new outlets.

Companies involved with the service industries such as banks, insurance, travel agencies etc. will own mainly office buildings. A large financial group or holding company would typical has a wide geographical spread of its properties in the form of branches.

Utility companies will own land reserves, rights of ways and easements for transmission lines, pipelines etc. Real estate owned by railway companies will include warehouse, workshops, storage buildings, rights of ways etc.

Table 2 : Types of corporate real estate

Business functions	**Types of CRE**
Administrative	Executive offices, general office, supporting office
Manufacturing	Fabrication, assembly, processing, refining
Utilities	Electricity generation, transmission, telecommunications, cable lines, microwave stations
Extraction	Mines
Agriculture	Farmland, timberland
Distribution	Warehouse, ports, pipelines
Retailing	Retail space, office, wholesale marts

Ownership of corporate real estate by corporations is motivated by the need for the firms to use the properties rather than for property investments. Warren (1996) pointed out that very often there is no investment market for corporate real estate e.g. oil refineries, easements for utilities and land reserves.

To assist in the classifications of CRE, Adendorff and Nkado (1996) identified two major types of real state owned by a firm i.e. strategic property and core property. Strategic property is real estate that firms need to own and control for its operations and long term business strategy. Examples of such properties are the manufacturing plants, warehouses etc. Core property refers to real estate that a firm needs to control for its existing and or future operations and for medium term business strategy. Examples of such properties are commercial, industrial or retail facilities from which the company operates.

2.0 Corporate restructuring strategies and corporate real estate

Corporate real estate reorganization and restructuring allow firms to sell assets, create new business units and change financial structure (refer Fig.1).

Restructuring refers to the significant changes in the strategies and policies relating to asset composition, liability and equity patterns as well as operations.

Asset restructuring will involve transactions that change the ownership and compositions of a firm’s CRE assets. Among the corporate actions that could be undertaken are the divestiture of business units, sale of property assets, spin-offs etc. Surplus property might be divested due to changes in business focus, changing technologies and manufacturing techniques.

Corporate reorganization and restructuring requires continuous attention and monitoring by corporate managers. For firms that have that have significant real estate, management needs to be alert and attentive to fully exploit the potential of the CRE resources.

FIG. 1 : BUSINESS STRATEGY AND CORPORATE REAL ESTATE REORGANISATION & RESTRUCTURING

Business Strategy

Identify key business drivers

Market Financial Process Resources

Space Analysis

Real Estate Needs Appraisals

Units Location Size Specification Cost Design

Flexibility Facilities

Analyse & match to current portfolio

Corporate Real estate Strategy

Identify & evaluate options

& plan strategic real estate plans

CRE rerganisation & restructuring

Implementation

Relocation Rationalisation Outsourcing Refit Sale

Acquisition Joint venture Disposal

Corporate real estate reorganization and restructuring can create valuable strategic and financial benefits for companies that are financially distressed and also for the financially sound. Diversified conglomerates benefit from reorganization and restructuring by selling off assets in unrelated lines of business. The process of reorganization and restructuring creates the organizational change necessary to facilitate the implementation of more efficient managerial decision making.

There are four generic corporate restructuring strategies and each will have an impact on corporate real estate :

(a) Business portfolio restructuring
(b) Financial restructuring
(c) Operational restructuring
(d) Organisational restructuring.

(a) Business portfolio restructuring

A company will normally comprise of several strategic business units (SBUs). Business portfolio restructuring will identify those SBUs which create value and those that do not. The restructuring will remove, add or maintain existing SBUs. The objective of restructuring is achieved by one of the following forms : divestitures, divestment, M & A, closures etc.

A divestment of SBU will invariably involve the selling out of its business together with its associated land and buildings. Unproductive SBUs are closed down. Sometimes when a whole division is sell-off, it is difficult to isolate corporate real estate from the business.

Firms may choose to sell so as to harvest its successful investments make in the past. With favourable market conditions, a firm may sell so as to meet meet new investment opportunities.

A firm may also sell so as to reverse its investment mistakes. The firm could have ventured into property investments at a high price and with change in economic conditions may force the firm to divest the property.

(b) Financial restructuring

When the cash flow in a firm is not sufficient to cover current obligations, the firm is in financial distress. The firm would normally undergo financial restructuring. The assets and liabilities of the firm are restructured to solve the financial problems. To free-up cash flow, a firm can sell its assets, reduce its labour force, capital expenditure and R & D. Financial restructuring is generally aimed at rearranging the financial commitments of the company to match with its restructured cash flows. The objectives of financial restructuring are to ensure shareholders are financially better-off compared to liquidation; to achieve equitable returns/recovery to all shareholders; and to enhance shareholder value.

A company may wrongly diversify into the property sector during the peak of the economy. With a downturn in the economy, the company may now find the cash-flow of the company to be severely affected. The company may then undergo financial restructuring by restructuring its financial commitments.

The options available for the management may range from refinancing, receivership, liquidation and fund raising. Companies may refinance its corporate real estate or liquidate real estate that cause a financial strain on the companies balance sheet.

(c) Organisational restructuring

Very often the organizational structure is revamped or realigned to support the new corporate and business strategies of the company. Any such changes in organizational structure will affect operational and occupational corporate real estate.

Such restructuring activities are carried out to right size the organization to cut costs and increase productivity.

(d) Operational restructuring

Changes in technology and change in strategic objectives of the company will necessitate to undertake operational restructuring. Various cost reduction exercise could be undertaken by the management. These include reduction of significant overhead costs, integration of facilities and shedding of loss-making operations.

Operational restructuring exercises may also include revenue enhancement measures such as the utilization of excess capacity and the optimization of product/customer mix and pricing.

While the above are medium term actions, for the longer term, process improvement exercises are necessary to address structural deficiencies, improve efficiency, productivity and reduce costs on a permanent basis.

3.0 Techniques of corporate real estate reorganization and restructuring

3.1 Divestiture

During the early 1990s, diversification was the driving force behind many corporate acquisitions. Firms diversify risk by expanding into other often unrelated industries and markets. However, investors and analysts are better able to value companies that are focus on certain core business. Diversified companies are not fully valued due to information asymmetry. As a consequence, companies now pursue a divestiture strategy, a move towards demerger or divestment, so as to focus on core competencies and business activities.

Divestiture is also a strategy used to undo failed mergers and acquisitions. It is also used to mask past poor/mistaken investments.

A change in management may also lead to a divestiture as a change in business strategy may lead to a sell-off.

The most common form of divestiture is the sale of a division or subsidiary to a third party for cash or other assets. There are various terms being used to describe such transactions : disposal, bifurcation, divestment, disinvestment, sell-off, spin-off, split-ups etc. Currently there is no standard definitions for these terms.

In the case of corporate real estate, a divestiture transaction could be a single property, a business unit, division or subsidiary. Corporate real estate which provide the manufacturing space, office, marketing and production space are divested together with the business unit.

The firms generally use the divestiture proceeds to invest in other business segments, reduce borrowings, repurchase outstanding shares of capital stock or distribute a dividend to shareholders.

Divestitures also play a significant role in the business life cycle of a firm particularly during the maturity phase where operations are discontinued due to withdrawal from a particular market (e.g. cessation of business or operations), consolidation of operations (e.g. when scattered facilities are consolidated into fewer modern premises); and liquidations (Giroux 1987). Tough economic conditions and business environment are the causes that lead to discontinued operations.

Dranikoff, Koller and Schneider (2002) observe that divestitures are less common than acquisitions. Divestitures are ad-hoc and are made only after several years of poor performance. Divestitures are often made after long delays and under strained circumstances e.g. heavy losses and heavy debt burden. at fire-sale prices. Thus there is a strong bias against divestiture as the action signal weakness and even failure of the firm.

Rationales for divestitures

In the corporate finance literature, six basic hypothesis are offered to explain corporate real estate divestments :

(a) The losing operations hypothesis

Firms in financial distress may divest loss making properties to meet debt service payments. The sale could also increase liquidity and thus reduce the chance of bankruptcy of the parent company.

For example Far East Holdings Bhd. sold Selayang Mall, a suburban shopping complex to service debt and to reduce borrowings.

(b) Agency hypothesis

(c) Good news hypothesis

A divestment may signal that the firm is trading at a positive NPV. The divestment may enhance value by selling the property to a buyer which can better manage the property or the economic synergy between the property and the acquirer. The acquirer expects that he could obtain better performance for the property because of improved prospects for synergic benefits and be able to manage the property more efficiently. For example a firm acquire an adjoining industrial building to cater for future expansion.

(d) Bad news hypothesis

A divestment might be perceived by investors as bad news as it signals poor liquidity in he firm, losing operations, inefficiencies and anergy.

(e) Wealth transfer hypothesis

The value of a firm can be enhanced at the expense of debt-holders by divesting some of the assets of the firm. The value of a firm is the sum of the values of debt and stock, a constant firm value implies that a decrease in the value of debt will be accompanied by an increase in stock value.

3.2 Acquisitions

Acquisitions are very often referred to in the literature as the takeover acquisitions of entire firms. Such acquisitions are usually news that makes the headlines of newspapers. But there are also transactions which involved the acquisitions of individual properties, business unit/sections/divisions. Such transactions may be termed as partial acquisitions. The differences between takeover acquisition and partial acquisition are (Alexandrou and Sudarsanam 2001) :

(a) the size of the acquisition;
(b) the complexity of the deal;
(c) transactions costs;
(d) the need for post-acquisition restructuring;
(e) the ease of integrating the acquired business with the buyers business.

Acquisition is carried out to implement a company's corporate strategy. The reason for property acquisitions varies. Very often real estate is acquired for the company's own business activities such as production, marketing, administration, training, development and R & D. To meet its business expansion needs, firms may purchase new properties to be closer to their markets, to expand into a new market or product line or to increase production capacity. To achieve cost savings or operating efficiency, new facilities might be purchased to reduce operating costs (e.g. labour, rent).

There are wealth gains for the acquiring firm in partial acquisitions due to :

(a) strategic gains in the acquisition;

A firm may buy the adjoining property which runs a similar manufacturing/business property by another firm because of operating synergy or operating economies. The source of operating economies may represent a form of economies of scale.

(b) the ability of the buyers to develop the acquired business to create wealth;

(c) the relative bargaining power of the buyer and seller.

4.0 Corporate restructuring in Malaysia

The Asian financial crisis in 1997-1998 has brought about considerable financial and economic stresses on corporate firms in Malaysia.

The aftermath of the crisis is that weak corporate companies have to undergo considerable reorganization and restructuring. The crisis has exposed the usage of sub-optimal financing techniques by corporate firms. For example the use of short term borrowings to fund long term projects. Many such companies have to undergo financial restructuring to restore its balance sheets. Several financial restructuring techniques are commonly used. These include debt-equity conversion, debt rescheduling and foreclosure.

Other companies may need to undertake operational restructuring to ensure corporate survival and sustainable growth. Among the activities commonly undertaken are change in management, refocusing core business, productivity improvement programmes and the consolidation and rationalization of assets and business.

A refocusing of core business activity may lead to disposing non-core assets. Plants that are in excess capacity are to be closed down. Surplus corporate real estate in production, marketing and management will be reorganized and disposed under rationalization and consolidation activities.

Three cases of corporate real estate reorganization and restructuring that involve spin-off, disposal and sale and leaseback are used to illustrate the change in the thinking of management towards corporate real estate in Malaysia.

CASE 1 : SPIN-OFF OF CORPORATE REAL ESTATE

<u>IJM Plantations Bhd</u>

IJM Corporation Bhd, a construction listed company, plans to list its wholly owned subsidiary, IJM Plantations Bhd. (IJMP) on the KLSE. IJMP has a total of 80,000 acres of oil palm plantation land in Sandakan, East Malaysia.

The listing of IJMP is aimed at unlocking the value of its investments in plantation. Currently the construction and plantation income of IJM are lumped together resulting in a smaller ratio of return to assets. By creating a new listed entity i.e. through spin off, enable the two different businesses to be separated into two entities. This would allow analysts and investors to make proper valuation of the company's shares.

Upon listing IJMP aims to be a significant player in the oil palm industry. The company plan to double the acreage of plantation land in 10 years time.

(Source : The Star, 28 December 2002)

CASE 2 : SALE AND LEASEBACK OF CORPORATE REAL ESTATE

Malaysian Airline System (MAS)

MAS has been in the red since the 1997 financial crisis. To reduce its short term borrowings, MAS has undertaken sale and leaseback of its properties and aircrafts. MAS will sell four buildings including its corporate headquarter in Kuala Lumpur for RM2.2billion. Six Boeing 747-400 and two new Boeing 777-200ER will also undergo sale and leaseback transaction for RM3.9billion.

The sale and leaseback will raise cash amounting to RM6.1billion. The cash will be used to reduce its short-term loans by RM1.3billion and repay its yen-dominated loans of RM1.58 billion. The money would also be used for the purchase of five new aircrafts totaling RM2.4 billion. The balance of RM820 million would be used as working capital.

To facilitate the sale and leaseback transactions, two special purpose vehicles will be set-up. The objective of the sale and leaseback exercise is aim at freeing up capital tied up in its non-core activities and corporate real estate assets. The four properties have a total book value of RM1.8 billion :

Type of property	Location
Corporate headquarter	Jalan Sultan Ismail
A 34 st. office & workshop building	MAS Complex , Subang
A 21 st. complex	KLIA, Sepang
MAS Academy	Kelana Jaya

With the disposal, MAS will make a capital gains of RM400million from the property disposal and RM450 million from the aircraft disposals.

(Source : The Edge, 5 August 2002)

CASE 3 : DISPOSAL OF NON-CORE CORPORATE REAL ESTATE & ASSETS

KFC Holdings (M) Bhd.

In a move to streamline operations, KFCH proposed to sell all its non-core and non-related assets. Among its corporate real estate to be disposed are the 22-storey Wisma KFC along Jalan Sultan Ismail, a chilli plantation and a soya bean factory.

Reflecting the change in the perception of the management towards corporate real estate, this is the comments offered : "*We do not need a huge building. We just need a few floors for a corporate office which we could rent, so we will sell Wisma KFC,* " said Johari Abdul Ghani, the managing director.

The reorganization and asset disposal of KFCH will place KFCH in a better position to move ahead in terms of profits and business in the future.

(Source : The Star, 4 January 2003)

5.0 Conclusions

While Iskandar (1996) found that operational properties owned by large companies and public corporations in Malaysia are underused and undermanaged, the current change in the view from "*we are not in the real estate business*" to an approach that convert CRE into cash through strategies such as sale and leaseback, spin-off, disposal and acquisition is a big step forward in realizing the hidden and neglected CRE values.

With greater realization on the potential of CRE in company balance sheets, it is expected that more corporate reorganization and restructuring involving corporate real estate will be carried out.

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